United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

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United States Court of Appeals

For the Second Circuit

In re APPLIED LOGIC CORPORATION,

Bankrupt.

NEW JERSEY NATIONAL BANK,

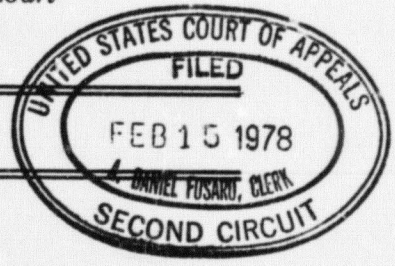
Plaintiff-Appellant,

-against-

DANIEL GUTTERMAN as Trustee of
APPLIED LOGIC CORPORATION, Bankrupt,

Defendant-Appellee.

On appeal from the United States District Court
for the Southern District of New York



APPELLANT'S REPLY BRIEF

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DANIEL GUTTERMAN, as Trustee of
APPLIED LOGIC CORPORATION,
Bankrupt.

Defendant-Appellee.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

APPELLANT'S REPLY BRIEF

INTRODUCTORY STATEMENT

The brief submitted by ALC (cited "Appellee Brief") fails to meet the main arguments made in our brief (cited "Appellant Brief") and, in addition, contains a number of

factual misrepresentations and erroneous statements of applicable legal doctrines.

Without unduly burdening the court with legal arguments already covered in our brief, we will focus upon the specific factual misstatements and erroneous conclusions of law in most urgent need of correction.

FACTUAL MISSTATEMENTS

The ALC brief is replete with factual misstatements made without any citation or basis in the record. For example, ALC contends that ALC was insolvent when the 1970 Agreement was executed. (Appellee Brief pp. 6, 19, 26). This is not supported by the record. The record only shows that Bank admitted in the pleadings that it knew of ALC's insolvency in December 1974 when it exercised its set-off against the Account, not in 1970. (A-86, 97).

ALC asserts, without any citation to the record, that pursuant to the 1970 and 1971 Agreements, ALC's board of directors was replaced by a slate headed by the Bank's executive vice-president. (Appellee Brief, p. 1). The record, however, clearly shows that the 1970 and 1971 Agreements never required Bank's vice-president to head or even to be elected to ALC's board (A-74, 75).

More serious still, ALC consistently states that Bank represented to other creditors a party to the 1970 Agreement, that it would not exercise its right of set off (Appellee Brief, pp. 30, 31), while the record developed at trial unequivocally shows that Bank only represented it could not exercise its set off rights as long as the 1970 and 1971 Agreements were not in default. (A-371, 372). (Appellant Brief, Point I, generally; pp. 26-28).

While ALC boldly argues without any citation to the record that the Bank failed to reserve its set off rights in the 1970 and 1971 Agreements or in the May 1971 $100,000.00 demand note (Appellee Brief, p. 52), the record unequivocally shows that the demand note, specifically reaffirmed by the 1971 Agreement, empowered Bank "to retain and apply any money, securities, or property of any kind" belonging to ALC for the payment of any and all obligations due Bank from ALC. (A-27, 72). (Appellant Brief, p. 30).

ALC's brief vainly attempts to limit the scope of Bank's secured interest in ALC's unencumbered assets to $40,000.00, the proceeds of the physical assets of ALC. (Appellee Brief, p. 44). At trial, however, counsel for ALC

clearly conceded that $56,000.00 was due and owing the Bank on its secured loan and could be offset by Bank against any recovery by ALC. (A-276). The record clearly shows that Bank would be entitled to set off of at least $56,000.00, not $40,000.00 as held by the bankruptcy court below. (Appellant Brief, Point III).

POINT I

ALC MISCONTRUES THE HOLDING OF THE BANKRUPTCY COURT BELOW WHICH HELD THAT THE ACCOUNT WAS NOT A SPECIAL BUT A GENERAL ACCOUNT WHICH IN THE ABSENCE OF ESTOPPEL, COULD BE SET OFF BY BANK

ALC repeatedly misconstrues the holding of the bankruptcy court below by contending that the bankruptcy court held that the Account was a special account against which Bank could not set off because of lack of "mutuality of debts and credits," rather than a general account against which it could. (Appellee Brief, Point I). Thus, at various times ALC characterizes the bankruptcy court's holding on the nature of the Account as a "close out account," "special," "non-general," "not made in the ordinary course" and "unique." (Appellee Brief, pp. 12, 19, 22, 27, 29).

The bankruptcy court below, however, specifically found that the Account was general in nature which in the absence of alleged misrepresentations by Bank to the other creditors a party to the 1970 Agreement, could be set off by the Bank. Thus, the bankruptcy court below said:

> "While the funds raised pursuant to the 1970 and 1971 agreements and deposited to ALC's bank account and subject to its check for general purposes may not be said to come within the accepted definition of a special deposit so as to be insulated from the plaintiff's right of set off, the circumstances under which the funds were raised, and the cooperation of the Bank and ALC in their creation, were sufficient to so far impress upon it the [equitable] character of a trust fund that the bank should be estopped to assert a lien thereon or the right of set off. Union Bank & Trust Co. v. Loble, 20 F.2d 124, 126 (9th Cir. 1927), cert. denied 275 U.S. 545 (1927)." (Emphasis added). (A-475, 476).

The court went on to articulate the elements constituting estoppel in this case and said:

> "Here I am satisfied that the elements of an estoppel are clear. The admitted facts are such that the plaintiff, confronted with the apprehensions of the other creditor banks that the depository bank could assert a right of set off, represented that

> it would not be in a position to do so. On this, the other creditors relied and changed their position to their detriment. The plaintiff Bank, which was a lead bank in a relationship with the other bank creditors, should not be permitted to reap the advantages of the privileged position it gave itself." (A-477, 478).

Contary tc ALC's contention, the so-called "lead" position which Bank took in the creation of the Account, its alleged orchestration of the 1970 and 1971 Agreements, were all elements which together with the alleged misrepresentations, were to the bankruptcy court's view, sufficient to impress a constructive trust on the Account based on principles of estoppel.

ALC attempts to justify the holding of the bankruptcy court below on the special versus general account issue, instead of the issue of estoppel which was neither pleaded (Appellant Brief, Point IV) nor supported by any evidence from the record below showing any Bank misrepresentation to other creditors (Appellant Brief, Point I) because the special versus general account issue was resolved by the bankruptcy court in Bank's favor. (A-475).

ALC's conclusion that the other creditors would have required the Account to have been kept in a non-creditor bank had they known of Bank's intention to place itself in a preferred position (Appellee Brief, p. 40) is mere idle speculation. No creditor even testified at trial on Bank's alleged misrepresentations, let alone on what course would have been taken had Bank's misrepresentations been known.

Under any proper reading of Judge Babitt's opinion, it is manifest that the court below, after having decided that the Account was general in nature, laid out the improper holding of Dudley as a Procrustean bed,[1/] upon which facts neither pleaded or proven in this case, were stretched in the hope of achieving a proper fit. Katz v. Glenhead National Bank, CCH Bktcy. Rep. ¶66,566 (2d Cir. 1977); see also Appellant's Brief, Point II, B generally.

POINT II

SECTION 70e OF THE BANKRUPTCY ACT DOES NOT GIVE ALC'S TRUSTEE STANDING TO SUE BANK FOR ALLEGED WRONGFUL MISREPRESENTATIONS TO THE INDIVIDUAL 1970 AGREEMENT CREDITORS, WHICH INDIVIDUAL CREDITORS WERE THE ONLY PARTIES INJURED AND THE ONLY ONES WHO SHOULD PARTICIPATE IN ANY RECOVERY.

1/ Procrustes - A robber from classical mythology who stretched or amputated the limbs of travelers to make them conform to the length of his "Procrustean" bed. He was killed by Theseus. EDITH HAMILTON, MYTHOLOGY, Mentor Book Pub. 1963, p. 150.

ALC at least concedes that the purpose of the requirement in the 1970 and 1971 Agreements for ALC to maintain "working capital" in the Account with the Bank was for the benefit of the creditors a party to those Agreements. (Appellee Brief, pp. 36, 50). Indeed ALC further concedes that ALC would have used the "working capital" in the Account in its business had the Bank allowed it to do so. (Appellee Brief, p. 27).

ALC asserts that it has standing under Section 70e of the Bankruptcy Act to avoid transfers made to Bank under conditions of alleged misrepresentation to other creditors who were parties to the 1970 Agreement.

There are three reported decisions which bear on this question. The first, Elliot v. Glushon, 390 F.2d 514 (9th Cir. 1967), involved a suit by a trustee under Sections 70e, 60 and 67 of the Act to set aside an alleged fraudulent and preferential transfer. One of the defendants allegedly conspired in the making of the transfer. The issue presented there was whether the trustee could hold the alleged aider and abettor in the transfer, who had actually not received the funds, liable under Section 70e of the Act. The court

there held that Section 70e does not, by its terms, grant the trustee standing to sue a party, who had not received the transfer, for the wrongful act which may have arisen out of the consequences of the transfer. Thus, the court said, at page 516, that the legislative theory is cancellation, not the creation of liability for the consequences of a wrongful act. Elliot v. Glushon, id., at p. 516.

The second case, Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 410 F.2d 135 (7th Cir. 1969), involved an action by the trustee of a brokerage firm against another brokerage firm alleging security fraud violations arising out of the unlawful conversion of the funds of the customers of the bankrupt brokerage firm by the defendant. The court (at pp. 137, 138) specifically held that the trustee had standing under Section 70e of the Act to avoid transfers made of customer securities and funds to the defendant brokerage house even if the bankrupt itself could not assert that cause of action.

In the third case, Bondy v. Chemical Bank, (S.D.N.Y. 10/30/75) CCH Fed. Sec. L. L. Rep., ¶95,360, there is language which however, indicates that a SIPA[2/] trustee (equated to a bankruptcy trustee) does not have standing to bring an

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2/ Securities Investors Protection Act of 1970, 15 U.S.C. §§780, 78aaa et seq.

action under Section 70e where the injury claimed is not to creditors or customers generally but only to specified individuals. Thus, in Bondy the trustee brought an action under anti-fraud provisions of the Securities Act[3/] for wrongful hypothecation of customer securities by the defendant bank. The court held the trustee had standing to sue following the Buttrey case. Another cause of action raised by the trustee dealt with market manipulations wherein the bankrupt brokerage firm and defendant bank aided and abetted the manipulation of stock belonging to certain customers of the bankrupt brokerage firm which resulted in a securities fraud upon those customers. Judge Metzner struck out this claim, based on two theories, on the following rationale:

> "The claim paints a market manipulation whereby Morgan, Kennedy, aided and abetted by Chemical, drove up the price of HDS stock, and sold it short to its customers at highly inflated prices. It is certainly true that the complaint makes out an allegation of securities fraud. However, in this court, it fails to allege any transfer of property to Chemical belonging either to Morgan, Kennedy, or to a customer of Morgan, Kennedy. The trustee may sue under the securities laws on behalf of creditors, but only to recover transfers pursuant to his authority under SIPA and Section 70(e) of the Bankruptcy Act.

3/ Section 17 of the Securities Act of 1933, 15 U.S.C. §77q, and Rule 10b-5 promulgated by the SEC thereunder, 17 C.F.R. §240.10b-5.

> See Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc., supra at 139; Caplin v. Marine Midland Grace Trust Company, 406 U.S. 418, 431-34 (1972). As one court has written: 'The legislative theory is cancellation, not the creation of liability for the consequences of a wrongful act.' Elliot v. Glushon, 390 F.2d 514, 516 (9th Cir. 1967).
>
> Furthermore, this claim is not based on injury to the creditors or customers generally, but only to those customers who bought the stock. They are the ones who have been injured and are the only ones who should participate in the recovery. Thus, they are the proper plaintiffs, and not the trustee who would make any recovery available to all customers and creditors, 15 U.S.C. §78fff(c)(2)(B). The fifth claim is dismissed." (Emphasis added) Id., at p. 98,784.

Therefore, it appears that the Bondy case limits the holding of Buttrey to situations where the trustee sues on behalf of all the creditors, but not in situations where recovery should properly be limited to the few creditors actually harmed by a defendant's alleged wrongful acts.

Assuming, arguendo, that Bank's wrongful misrepresentations to the 1970 Agreement Creditors that they would all share ratably in the Account is sufficient to impose a constructive trust on the Account in favor of those creditors

based on equitable principles of estoppel, any liability created from the consequences of these alleged wrongful misrepresentations would only create a cause of action in favor of those creditors, not the trustee whose recovery would result in recovery for all of ALC creditors. Bondy v. Chemical Bank, supra; Elliot v. Glushon, supra.

Those 1970 Agreement Creditors which might have suffered from these alleged misrepresentations were known to the trustee of ALC. (A-17a-m). Had any misrepresentations been made by Bank to them, they could have come forward at trial, or sued on their own account in the same manner as many filed claims. (A-17a-m). No creditor came forward during the course of the instant proceeding, none have sued individually although under Bondy they clearly could have done so. The facts point to one self-evident conclusion. No creditor was mislead, and if any were, they alone should recover from Bank's wrongful misrepresentations, not all ALC's creditors.

POINT III

THE COURTS BELOW EXERCISED AN ABUSE OF DISCRETION IN INVOKING SO-CALLED NOTIONS OF EQUITY IN TOTAL DISREGARD OF THE LEGISLATIVE PURPOSE AND STATUTORY MANDATE OF SECTION 68 OF THE BANKRUPTCY ACT

The courts below, invoking so-called notions of equity, denied Bank its set off right under Section 68 of the Act and common law for which Bank bargained in agreeing to waive debt due it under the 1970 and 1971 Agreements. Such invocation of unbridled discretion by bankruptcy courts to ex post facto disturb comprehensive workout agreements negotiated by the parties will no doubt have a chilling effect on the willingness of banks in the future to enter into such agreements. (Appellant Brief, Point II, B). The legislative history of Section 68, specifically intended to encourage banks to help extricate debtors from financial embarrassment, is thus being ignored in a great hurrah of unbridled exercise of so-called equitable discretion under Bank of Marin v. England, 385 U.S. 99 (1966). (Appellant Brief, p. 40, also see Point II, B generally).

The potential mischief of Bank of Marin v. England, in giving unbridled discretion to bankruptcy courts to flout the clear legislative purpose and statutory mandate of the Bankruptcy Act did not go unnoticed at the time of that decision nor by courts since. Bank of Marin v. England, id., at 106 (dissenting opinion, Harlan, J.). Shaw v. Walter E.

Heller & Company, 385 F.2d 353 (5th Cir. 1967). As Justice Harlan prophetically noted in Bank of Marin v. England:

> "The Court's principal contention seems to be that equitable considerations oblige it to release the bank from liability. Its premise plainly is that equity is here a solvent to which we may appropriately resort; I am unable to accept that premise. This is not a case in which the statute is imprecise. Nor is it a case in which the legislature's intentions have been misshapen by the statute's words; even a cursory examination of the history of §70 will evidence that its terms faithfully reflect Congress' purposes." Id., at p. 106.

See, Shaw v. Walter E. Heller & Company, supra, at 516, where an appeal concerning the application of equitable principles in a bankruptcy proceeding was summarily dismissed upon the authority of the above-quoted statement of Justice Harlan.

The holding of the courts below should be reversed, and direction should be given to the bankruptcy court below to permit Bank its setoff in conformance with the legislative purpose and statutory mandate of Section 68 of the Act.

CONCLUSION

For all of the foregoing reasons, the order appealed from should be reversed with respect to the "Counterclaims" of ALC and Bank should be granted all the relief requested in its complaint.

Dated: New York, New York
February 13, 1978

Respectfully submitted,

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By